



Article from

Pension Section News

Sept. 2016

Issue 90

INTERVIEW WITH Elizabeth Bauer



Elizabeth Bauer, FSA

TELL US A LITTLE ABOUT YOURSELF.

I'm a pension consulting actuary in my firm's international retirement practice, but I've also always felt a bit of a misfit, since I'm more interested in public policy and less technical than many of my colleagues. I had a circuitous route here, having studied medieval history as a graduate student before switching gears, and worked in the domestic actuarial practice for eight years before moving to an international focus 11 years ago. I enjoy learning about the differences in retirement systems, and the lessons they offer.

WHAT ATTRACTED YOU TO THE ESSAY CONTEST?

I enjoy reading and writing about public policy topics, but the latter largely takes the form of a personal blog, so I'm happy to

find opportunities to write for a (wider) audience and work out my thoughts in a more disciplined manner.

WHAT STEPS, IF ANY, WOULD HELP MAKE THE IDEAS IN YOUR ESSAY A REALITY?

I address three ideas in my essay. With respect to Social Security benefits as a "longevity annuity," there are already voices promoting the existing option to defer collecting benefits to age 70 where possible, so this holds the most promise of becoming integrated into the standard set of retirement planning recommendations. The extension of the age up to which benefits can be deferred with actuarially equivalent increases, is, I'd like to think, a small enough step to be possible with little political wrangling.

A Tom Harkin-style pooled retirement plan would require more political will because of the more complex enacting legislation. The last of these, making annuities more popular and a better value for the money, is of particular interest to me at the moment. It is striking to me that, in the year 2016 in the United States, many employers are concluding that the financially most sensible solution for their retirees' pension liabilities is to purchase annuities, which would have been unthinkable a decade or two ago, and at the same time, many of the pensions my colleagues in Europe deal with are funded via insurance contracts or even deferred annuities—products that are unthinkable in the U.S. individual retirement market. I'm hoping to learn more about these European insurance arrangements in my work and apply the lessons to the U.S. retirement system.

WHAT GROUPS WOULD NEED TO BE INVOLVED?

The "retirement industry" and the retirement punditry need to find a consensus; at the moment there seems to be, politically, a widening gap between those who believe that everything'd be just fine if Americans just saved more, and those who simply prefer an expansion of Social Security to (imagined) European levels of generosity. How to get past this I'm not sure.

WHAT ELSE WOULD YOU LIKE TO TELL US?

Hmm ... at the moment, I could tell you that the Moselle Valley town of Winningen is so cute you want to pinch yourself. But beyond that, I'm still trying to figure out how, in some small way, to play a role in moving the entire Future of Retirement issue forward. ■

Decumulation for a New Generation

By Elizabeth Bauer

How should we, as actuaries, think about the issue of decumulation/spending in retirement? And how should we, as pension actuaries, advise the public at large—or should we?

The answer seems obvious: Defined benefit (DB) plans, once the norm for employees at larger companies, have mostly disappeared for, say, Generation X, leaving them exposed to the investment and especially longevity risks from which they would have otherwise been protected by those pensions; hence, when they reach retirement age, these future retirees should be nudged/incited/required to annuitize some portion of their benefit.

But, up to now, retirees have stubbornly refused to do so—and, truth be told, with good reason:

- Annuities are expensive, when measured against actual and perceived alternatives.
- Consumers distrust annuities, and insurance providers.
- Employees are conditioned to think of defined contribution (DC) as a “pot of money” and want to get the full value, also they’re more afraid to “waste” money by dying too soon than “outliving” the money by dying too late

So, what to do?

THE PRICE OF ANNUITIES

Here’s a quick calculation of a money’s worth ratio (MWR): USAA, a mutual insurance company for service members and their children, offers an online annuity calculator. As of October 2015, a woman age 65 with \$100,000 could purchase, on a single-life basis, an annuity of \$498 per month. Using the most conservative annuity table readily available on my company’s annuity calculator, and the Sept. 30, 2015, Moody’s Aa corporate bond rate of 4.13 percent, produces a monthly benefit of \$553—that’s a MWR of 90 percent. Or, if I work backward to get an equivalent annuity factor, I get an implied actual discount rate of 3.13 percent, or a 100 basis point cost for expenses and margins for conservatism—and that’s assuming that USAA, which sells

online and by phone rather than via agents, has a lower marketing expense than a typical commission-based product.

Is that about right? According to the admittedly outdated information available online, money’s worth ratios are significantly worse in the United States than elsewhere. At a time when, on a corporate bond basis, the U.S. MWR was 0.80, for a 65-year-old female in an annuitant population, the equivalent ratio in Australia was 0.89, or 0.90 in the United Kingdom, 0–0.94 in Canada and 1.08 in Switzerland.¹ In the Netherlands, too, ratios are high.² In the Netherlands and in Switzerland, and formerly in the United Kingdom, annuitization is mandatory, reducing marketing expenses and antiselection issues. In addition, the annuities in question are deferred annuities, where the provider may offer more generous annuitizations subsidized by lower accumulation rates.

And how does a typical consumer determine whether this is “too expensive”? There seem to be three strategies retirees follow in deciding how to spend their assets: they either try to live off the interest, follow the “4 percent rule” now in common currency, or pick the age they expect to live to and work backward. This is, at any rate, what the Morningstar Guide to Retirement, which came in my newspaper a couple months ago as a Sunday supplement, tells me. (The guide didn’t have much to say about annuities, not surprising since they’d really rather you kept your funds invested with them.)

What does 4 percent buy you, on our sample \$100,000? A measly \$333 per month, which looks pretty lousy compared to our \$500 annuity, but it’s not apples to apples because the 4 percent rule is meant to offer inflation protection and a bequest to heirs in the event of untimely death, to boot. If I apply some rudimentary math to my employer’s annuity calculator, and assume a long-term inflation of 2 percent, that brings the initial benefit down to \$400; at a 3 percent inflation assumption, the benefit is \$345. In the real world, inflation-protected annuities don’t really exist; instead, they take the form of fixed annual increases. If you add in an expectation for higher expenses and fees than a fixed annuity, it could well be that the actual monthly payment for such an annuity might not be any better than this \$333. And whether the 4 percent rule is “right” in an absolute sense is not necessarily relevant; the point is that it looks like a good deal to a retiree engaged in financial planning.

What about the “pick a life expectancy” method? If we imagine that a retiree plans for living, say, 30 years in retirement, that is, to age 95, then at our corporate bond rate, they could plan on an income of \$485 per month. If they assume, because they’ll be investing in a diversified manner, a higher return, say 5 percent or 6 percent, they could plan on \$535 or even \$600. Is this a sensible strategy? Maybe not. Although it appears to nearly elimi-

nate longevity risk by means of this conservative assumption, it exposes retirees to investment risk. But to an individual retiree making plans, it looks appealing.

And “live off the interest”? Rates are low, but it offers the reassurance of no capital loss, and it offers retirees hope that, even though today’s interest rate environment is low, they haven’t locked themselves into anything and will gain when interest rates increase in the future.

HOW TO MAKE ANNUITIES A BETTER VALUE FOR THE MONEY

To a certain extent, it’s a catch-22: Costs are high because the customer base is small, requiring more in marketing/commission costs and more conservatism for antiselection; however, the customer base is small because the costs are high. To the extent that more customers would reduce expenses, one could imagine a set of **government subsidies** (e.g., tax credits) similar to those for hybrid cars, intended to incent consumers to choose annuities for retirement spend-down, but time-limited with a phase out as volume grows.

Even in a perfect market, in which the volume of annuity sales reduced their cost, there would still be the fundamental issue that asset returns on annuities are hampered by the need to invest in low-return fixed income products. Are there work-arounds? In 2014, Sen. Tom Harkin, D-Iowa, introduced the USA Retirement Funds Act,³ which, among other things, would have established a form of auto-enrollment based **pooled retirement fund**, which would have aimed at providing lifetime income for its participants, but with mechanisms for adjusting benefits as needed to protect the fund’s finances. Such a fund, due to its adjustment mechanisms, could have been less restricted to fixed income investments. In its final form, it might have offered Pension Benefit Guaranty Corp.-like protections outside the realm of employer sponsorship to further enable careful yet diversified asset allocation. Needless to say, the bill, which also included a catch-all set of pension funding and regulatory provisions, didn’t pass and didn’t appear to have generated much interest.

Was the bill inherently flawed? Perhaps it attempted too much, with the auto-enrollment provisions, for instance, or perhaps it was a matter of “wrong place, wrong time,” especially with Senator Harkin now having retired. It’s too facile an explanation to say it was doomed by partisanship, given that pension legislation has historically been bipartisan, even if it’s as simple as the periodic funding relief amendments tucked into larger must-pass legislation. More likely, this legislation had no support base, no constituency pushing for its passage in this or an amended form. The actuarial profession, despite growing concerns about the need for protection against longevity risk, has no real history of political advocacy, especially to the extent that pooled funds would appear to be competitor products to existing 401(k) funds and traditional

annuities (though, in principle, either of these types of providers could expand their business into a new market).

Harkin also envisioned these funds being offered by nonprofits (though perhaps managed by insurers, asset managers and employee benefit administrators), which might have **countered the current consumer distrust of annuities**. As actuaries, we know that the probabilities of death as an annuitant ages are simply baked into the pricing of the annuity, but too many consumers perceive the annuity as a “bet” the insurer makes with the consumer: If you die young, you lose and the insurer wins. To the extent that pooled funds can escape this perception, and can instead re-brand themselves as, similar to mutual insurance, shared risk among your fellow participants in the fund, this may offer a way forward here, too.

Absent these two changes, there’s another seemingly simple legislative change that could offer a cost-effect means of funding annuity income out of retirement savings. The full implementation of late retirement Social Security benefit increases, and the fact that benefits taken at age 70 are 76 percent higher than if taken at age 62, are beginning to make their way into media reporting, though those articles often contain the (quite reasonable) caveat that you don’t get “something for nothing” because the benefits are actuarially equivalent and, if you die young, you get nothing.⁴ But if the opportunity for actuarially equivalent increased benefits due to late retirement were extended even beyond age 70, to age 75, for instance, this would transform Social Security into a longevity annuity for those individuals who are able to spend down their savings in the intervening years, and who would value the longevity protection even at the risk of not collecting a benefit at all should they die early, in a cost-free manner. True, Social Security’s finances are uncertain, but nearly all proposals envision a tinkering around the edges rather than a major reworking of the entire structure.

If no political changes are on the horizon, perhaps there are opportunities for a re-marketing of annuities by means of a competitor in the “rule of thumb” business, advising retirees to direct some portion of their assets to an annuity rather than, or as part of, a bond asset allocation, using a formula keying off of Social Security, other pension benefits (if they exist) and total savings. Such a rule of thumb might be “cover your ‘age 85’ expenses with an annuity, and spend down assets on the rest”—with age 85 expenses defined as your basic daily living needs, stripping out the travel, the golf and perhaps even the maintenance that goes along with car ownership or keeping the four-bedroom family home. (What about medical care and long-term care? I’m hoping someone else figures that one out.) Or advice might be a modification of the standard asset allocation recommendation: To the extent you’re planning on investing in bonds as part of

your portfolio, there's not as much loss, in return expectations, in purchasing an annuity.

PROMOTING ANNUITIES

This all leads to a final question: Why aren't annuity providers doing more to promote their product themselves? I can guess—but only guess—that it's because direct-to-consumer immediate annuities are a small part of their product line and, perhaps, in an agent-based sales structure, agents are more keen on selling other products with higher commissions. Perhaps this will change, as Generation X heads to retirement as the first generation after the end of DB pensions, and as they (OK, *we*) must cope with making our way as the ever-ignored middle child, sandwiched between the two media-darling generations, the baby boomers and the new favorite, the millennials. What's more, the older generation knows annuities primarily as a high-fee retirement savings vehicle that made sense in a pre-401(k) era, when tax-deferred options were few; the lifetime income option is almost an afterthought. Perhaps this leaves them ripe for re-invention for a new generation.

CONCLUSION

The preceding is more a collection of ideas than a single new, compelling insight. Tax credits, pooled retirement plans, Social Security as longevity annuity, new rules of thumb—nothing new

under the sun here. But that's what's needed, isn't it? A variety of strategies and some hard work at implementation, along with an advocacy group that goes to bat for these ideas where political changes are needed. ■

ENDNOTES

- 1 G.A. "Sandy" Mackenzie, "The Role of Private Sector Annuities Markets in an Individual Accounts Reform of a Public Pension Plan," International Money Fund Working Paper WP/02/161 (2002).
- 2 Edmund Cannon, Ralph Stevens and Ian Tonks, "Price Efficiency in the Dutch Annuity Market," Netspar Discussion Paper DP 04/2013-16 (April 2013). The authors calculate their ratios on a government bond basis, which means they're not directly comparable to the others.
- 3 Text available at <https://www.govtrack.us/congress/bills/113/s1979>.
- 4 A quick Internet search turned up two items: Philip Moeller, "Delay Social Security Till Age 70? Not in The Real World," Time Money, May 23, 2014, and "3 Reasons It's Smart to Take Social Security Benefits at 62," The Motley Fool, Dec. 30, 2015.



Elizabeth Bauer, FSA, is a pension consulting actuary at Aon Hewitt. She can be reached at elizabeth.bauer@aonhewitt.com.